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No. 192

In the Supreme Court of the United States

OCTOBER TERM, 1932

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ALUMINUM GOODS MANUFACTURING COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The findings of fact and opinion of the Board of Tax Appeals (R. 10–21) are reported in 22 B. T. A. 1. The opinion of the Circuit Court of Appeals (R. 25–28) is reported in 56 F. (2d) 568.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 25, 1932. (R. 29.) Rehearing was denied April 4, 1932. (R. 30.) Petition for a

writ of certiorari was filed July 1, 1932 (R. 31) and granted October 10, 1932 (R. 31). Jurisdiction is conferred upon this Court by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether upon liquidation of a subsidiary corporation having insufficient assets to meet its obligations, a parent corporation may deduct as losses the cost of stock in the subsidiary and the unrecovered balance of advances made by it to its subsidiary, in computing the consolidated net income of the two corporations subject to the excess-profits tax for 1917.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are set forth in the Appendix. (*Infra*, pp. 20–29.)

STATEMENT

The facts as agreed upon by the parties and accepted by the Board of Tax Appeals (R. 10–15) may be summarized as follows:

In 1914 respondent, a New Jersey corporation engaged in manufacturing, purchased all the capital stock of the Aluminum Sales and Manufacturing Company, a New York corporation (hereinafter referred to as the Sales Company), for $29,749.80. Thereafter the Sales Company was principally engaged in selling goods manufactured by respondent and was primarily employed as an outlet for respondent's goods. The Sales Company made remittances to respondent from its collections and capital,

for goods purchased, maintaining a revolving fund to meet operating expenses. This fund was replenished by recurrent advances from respondent. The business conducted by the Sales Company in Indianapolis was discontinued in 1916, and the New York place of business was discontinued in 1917. The business of the Sales Company during 1917 consisted chiefly of liquidating its assets, and no business was transacted by it after that year. Certain assets were taken over by respondent and credited to its open account with the Sales Company. (R. 10–11.) At the close of 1917 the amounts owed by the Sales Company to respondent for advances and merchandise totaled $47,486.31. Respondent charged off its books a portion of these advances on December 30, 1916, and the balance on December 31, 1917. These sums were not repaid. Respondent charged off on its books the $29,749.80 invested in the capital stock of the Sales Company, a portion on December 31, 1916, and the balance a year later. (R. 11.) So far as the record shows the process of liquidation was not completed before the close of the year 1917. The Sales Company was dissolved in February, 1918. (R. 13–14.)

Up to and including 1916 the respondent and the Sales Company made separate returns for tax purposes. (R. 12.) The Sales Company sustained losses for 1914, 1915, and 1916. (R. 11.) It sustained an operating loss in 1917 which was allowed by the Commissioner as a deduction in that year. (R. 12.)

For the year 1917 respondent filed a separate return for normal tax purposes and a consolidated return with the Sales Company for excess-profits tax purposes. In the separate return for 1917 respondent claimed and petitioner allowed a loss for normal tax purposes consisting of the total of advances to the Sales Company together with the purchase price of the stock, less the value of the equipment and good will received upon liquidation of the Sales Company. A similar loss was claimed for excess-profits tax purposes, less the 1917 operating loss of the Sales Company. (R. 12.) This the Commissioner disallowed. (R. 12.) The Board sustained the determination of the Commissioner. (R. 21.) Upon petition for review the Circuit Court of Appeals reversed and remanded the case to the Board of Tax Appeals. (R. 29.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred—

1. In holding that when upon the liquidation of the Sales Company its stock became worthless and advances made to it by the respondent became uncollectible, the cost of the stock and the unpaid advances could be deducted as losses upon the consolidated excess-profits tax return of the affiliated corporations for 1917.

2. In reversing the judgment of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

The loss claimed herein is not an allowable deduction in computing the *consolidated net income* of the

respondent and its subsidiary. War excess-profits taxes of affiliated corporations for the year 1917 were required to be computed upon the basis of consolidated returns of net income and invested capital. Respondent and its subsidiary were affiliated throughout the year 1917 and until the dissolution of the subsidiary in 1918. Mere liquidation of the assets of a subsidiary does not terminate affiliation.

The primary purpose of requiring consolidated returns was to levy taxes according to the true net income and invested capital resulting from and employed in a single business enterprise. To effectuate that purpose it is essential in computing the consolidated net income for affiliated corporations that all intercompany transactions, whether resulting in gain or loss, be eliminated. The losses in question occurred in intercompany transactions. Hence such losses, although allowed as deductions to the respondent in computing its separate net income for the normal tax, may not be allowed as a deduction in computing the consolidated net income of the respondent and the Sales Company for excess profits tax purposes. To permit the deduction of such losses on a consolidated return of net income would amount to carrying forward all the operating losses of the subsidiary for prior years and in effect would be to levy the profits tax on the basis of the respondent's separate net income but at rates measured by the consolidated invested capital, for which there is no authority in law.

Even if it should be held that affiliation in this case was terminated upon liquidation, nevertheless the decision of the Board of Tax Appeals was correct. The court below held that the loss was suffered upon termination of affiliation, which occurred, so it was held, when the Sales Company was liquidated in 1917. Under this ruling there could be no change in the amount of the consolidated excess-profits liability as determined by the Commissioner and sustained by the Board, because it was stipulated that the Sales Company was liquidated on December 31, 1917, and accordingly there was no income received after affiliation against which such loss might be offset. Hence, a recomputation of respondent's tax liability for 1917, even in accordance with the conclusions of the court below, would result in the same deficiency as that set forth in the decision of the Board of Tax Appeals.

ARGUMENT

The Revenue Act of 1917 under Title II imposed a war excess-profits tax (in addition to the normal income tax) upon the income of corporations, at varying percentages of the net income in excess of specified amounts. The statute originally made no provision for consolidated returns of income by affiliated corporations, but the Treasury Regulations adopted pursuant to the Act did provide that the excess-profits tax of affiliated corporations should be computed upon the basis of consolidated returns of net income and invested capital. Regulations 41,

Articles 77, 78. The Revenue Act of 1918, Section 240, c. 18, 40 Stat. 1057, 1081, expressly provided for consolidated returns by affiliated corporations, and the Revenue Act of 1921, Section 1331, *infra*, p. 27, provided that for the purpose of determining excess-profits taxes the Revenue Act of 1917

> shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.

The manifest purpose of requiring consolidated returns by affiliated corporations was to impose the war taxes according to the true net income and invested capital of what was a single business enterprise, even though conducted by means of more than one corporation. See *Handy & Harman* v. *Burnet*, 284 U. S. 136, 140; *Gould Coupler Co.*, 5 B. T. A. 499, 516. This purpose could be effectuated only by treating affiliated corporations as a unit and by eliminating in the computation of the net income and invested capital of the group all duplications in capital and all intercompany transactions. These fundamental principles find expression in the Treasury Regulations under the Revenue Act of 1918 and subsequent Acts. See Regulations 45, Art. 637; Regulations 62 and Regulations 65, Art. 636; Regulations 69,

Art. 635; Regulations 74, Art. 734; Regulations 75, Articles 31 and 38(b). This consistent administrative interpretation of the Revenue Acts has implied legislative approval and should be given the force and effect of law. *Brewster* v. *Gage*, 280 U. S. 327, 336–337.

In the instant case it is apparently unquestioned that respondent and the Sales Company were affiliated corporations throughout the year 1917 and hence were required to make a consolidated return of net income for the excess-profits tax, as provided in the statute and regulations. The Sales Company continued in existence throughout that year and all its stock was then owned by the respondent, although it was engaged principally in closing out its business and by the end of the year had completed liquidation by transferring its remaining assets to its parent, the respondent. The stock of the Sales Company had been purchased for cash by the respondent from outside interests in 1914, and from that time until liquidation the respondent advanced to the Sales Company such sums as were required for operation. Upon the liquidation of the Sales Company there remained no assets from which the respondent could recover the cost of the stock or reimburse itself for unpaid advances. These two items aggregated $66,551.55. The Commissioner allowed the respondent a deduction of that sum as a loss in computing its separate

net income for 1917 normal tax.[1] The respondent claimed that the loss of stock investment and advances made by it to its subsidiary, less the 1917 operating loss of the Sales Company which was allowed by the Commissioner, or the net amount of $51,861.90, was an allowable deduction in computing the consolidated net income for 1917 subject to the excess-profits tax. The Commissioner disallowed the claimed deduction.

The court below, despite the statutes and administrative practice discussed above, held that the deduction was properly claimed and should have been allowed. In so holding it concluded that affiliation between respondent and the Sales Company was terminated by the latter company's liquidation and that, therefore, the losses involved in the present claim occurred outside the period of the affiliation of the two companies. It concluded further that, even were the case otherwise, neither the loss sustained by respondent in its purchase of the stock of the Sales Company nor the loss sustained through its loans and advances to the Sales Company were suffered in intercompany transactions. The order of the Board of Tax Appeals upholding the Commissioner was therefore reversed.

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[1] It should be noted that for the year 1917 only the war excess-profits tax of affiliated corporations was to be computed upon the basis of consolidated returns of net income and invested capital. The normal income tax of affiliated corporations was to be computed upon the basis of their separate net income.

For the purpose of this case it is assumed that the stock and the debt became valueless upon liquidation.

I

AFFILIATION OF THE RESPONDENT AND THE SALES COMPANY WAS NOT TERMINATED BY THE LIQUIDATION OF THE LATTER IN 1917. TRANSFERS OF PROPERTY BETWEEN THE RESPONDENT AND ITS SUBSIDIARY WERE THEREFORE INTERCOMPANY TRANSACTIONS WITHIN THE AFFILIATED GROUP, WHICH MUST BE DISREGARDED IN THE COMPUTATION OF CONSOLIDATED NET INCOME

The court below was of the opinion that the mere liquidation of the Sales Company terminated the affiliation between it and the respondent. This conclusion is unsound and apparently rests upon the erroneous assumption that only active corporations may be affiliated. Treasury Regulations 41, promulgated under the Revenue Act of 1917, Art. 77 (*infra* p. 29), provided that, for purposes of returns under the war excess profits tax, "* * * two or more corporations will be deemed to be affiliated (1) when one such corporation owns directly * * * all or substantially all of the stock of the other or others * * *." The Revenue Act of 1921, Sec. 1331 (*infra*, p. 27), gave legislative sanction to the administrative requirement that affiliated corporations file consolidated returns for excess profits tax purposes, and provided that, under the Revenue Act of 1917, a corporation was to be deemed affiliated with one or more other corporations "(1) when such corporation * * * owned directly * * * all or substantially all the stock of the other or others." There is nothing in the statutes or regulations which suggests that, so long as the ownership or control upon which affiliation depends continues, it is neces-

sary that all of the affiliated corporations should be actively engaged in business. The wording of the statute is plain; it clearly states that ownership by one corporation of the stock of another shall be the test of affiliation. In the instant case, although the Sales Company transferred its assets to the respondent at the close of 1917 its stock was still outstanding and owned by the respondent, and the existence of the two corporations as separate but affiliated corporations continued. In *Autosales Corporation* v. *Commissioner*, 43 F. (2d) 931, 933 (C. C. A. 2d), it is pointed out that the mere inactivity of the subsidiary is immaterial and indeed presents the very situation in which the economic unity of the two corporations contemplated by the affiliation provisions of the statute is most apparent.

In *Utica Knitting Co.* v. *United States*, 68 C. Cls. 77, certiorari denied, 281 U. S. 739, the Court of Claims upon closely similar facts held that the liquidation of the subsidiary did not terminate the affiliation within the taxable year, and that the loss of the stock investment and loans, thereby sustained by the parent corporation, were sustained in an intercompany transaction and were not allowable deductions in computing consolidated net income of 1917 for profits-tax purposes. The court said (pp. 87–88):

> We can not agree with the contention of plaintiff that the fact that the subsidiary company in 1917 manufactured no products, incurred no expenses or liabilities, that its sole activities were to collect certain accounts

and to pay certain debts, to wind up its affairs, and to turn over to plaintiff all its property, in any way relieves plaintiff and its subsidiary from the provisions of section 1331, above quoted. The relations between plaintiff and the Unitee Knitwear Company continued, and they were a unit until the latter company was finally liquidated in December, 1917.

It would be an extremely technical evasion of the purpose of the statute to hold that a conceded affiliation ceases when the subsidiary ceases to sell and manufacture goods, while at the same time the parent company owns all the stock of the subsidiary, and the subsidiary continues in business for the purpose of winding up its affairs, turning over its property to the parent, collecting its accounts, and paying its debts, which very debts and accounts arose out of the knitwear business in which both the parent company and the subsidiary were engaged.

The commissioner was correct in refusing to consider the intercompany transactions between plaintiff and its subsidiary, with reference to the excess-profits tax. The very purpose of section 1331 of the revenue act of 1921, *supra*, was to treat affiliated corporations as an entity, or a business unit, and to eliminate intercompany transactions.

The liquidation of a subsidiary corporation and the transfer of its assets to the parent corporation has long been treated by the Bureau of Internal Revenue as an intercompany transaction, and any gain or loss n respect of the stock investment or loans by the

parent resulting from such a liquidation has been consistently disregarded in computing the consolidated net income of the affiliated corporations. Sol. Op. 131, C. B. I–1, p. 18; G. C. M. 1501, C. B. VI–1, p. 260; G. C. M. 2774, C. B. VII–1, p. 196. This Bureau practice ultimately found expression in Treasury Regulations 75, Art. 37, and is entitled to consideration and weight. See *McCaughn* v. *Hershey Chocolate Co.*, 283 U. S. 488, 492.

The practical reason for this administrative practice is clear. As shown above, the primary purpose of the provisions for consolidated returns is to reflect accurately the true financial condition of a business enterprise by disregarding the corporate units which compose the whole. The liquidation of a subsidiary does not affect the group holdings differently from a sale within the group. In the present case, when the Sales Company liquidated, the income or assets of the group composed of itself and petitioner were neither increased nor decreased. A consolidated balance sheet constructed after the liquidation would show the same net worth as before, and, for tax purposes, the transaction is the same as the discontinuance of a branch or department of a single corporation. Not only is this true of the stock of the subsidiary, but it is equally applicable to the loss of the alleged bad debt consisting of advances made by the parent. The writing off the amount of the open account between petitioner and the Sales Company resulted in neither gain nor loss to the affiliated group.

The cases referred to by the court below as supporting its conclusion that the affiliation was terminated by the liquidation, and hence that the losses were sustained outside the period of affiliation, may be distinguished.

In *Remington-Rand, Inc.* v. *Commissioner*, 33 F. (2d) 77 (C. C. A. 2d), certiorari denied, 280 U. S. 591, the parent corporation sold the stock of its subsidiary to outside interests and thus terminated the affiliation; a *separate* return was filed for the period between the time of such termination and the end of the taxable year involved. The Board of Tax Appeals held that the transaction resulted in neither gain nor loss. The Circuit Court of Appeals reversed on the ground that the sale terminated the affiliation which resulted from the original purchase of the stock of the subsidiary; both the purchase and sale, it was held, took place outside the period of affiliation and were for the parent corporation's own account, not for the account of the affiliated group. *Utica Knitting Co.* v. *United States, supra,* is in effect distinguished in the opinion in the *Remington-Rand case* (p. 78):

> *Whatever may be the rule where affiliation continues after the sale,* under the facts of the instant case we think the board erred in ruling that neither taxable gain nor deductible loss resulted to the parent company from the sale of the stock. (Italics ours.)

The fact that certiorari was denied in both the *Utica Knitting Co.* and the *Remington-Rand cases* is persuasive that the decisions are not in conflict.

In *United Publishers' Corporation* v. *Anderson*, 42 F. (2d) 781 (S. D. N. Y.), there was also a sale of the stock to outside interests, and the court, upon authority of the *Remington-Rand case*, held that the resulting loss was deductible on a *separate* return for the ensuing period. In *Burnet* v. *Riggs National Bank*, 57 F. (2d) 980 (C. C. A. 4th), a merger equivalent to dissolution of the subsidiary took place and the shares of the subsidiary stock owned by the parent corporation were surrendered in exchange for assets. Here again the loss was allowed as a deduction against *separate* income for a period subsequent to affiliation. In *Canal Commercial National Bank*, 22 B. T. A. 541, there was an actual dissolution on the same day that the liquidation occurred. The gain realized was solely that of the parent company and was not reflected in the consolidated income of the affiliated corporations (p. 550).

In *American Printing Co.* v. *United States*, 53 F. (2d) 98 (D. Mass.), the subsidiary ceased to do business on December 31, 1917, and was dissolved by decree of court "soon thereafter" (p. 98). The taxable year was 1919 and affiliation had apparently ceased some time before the beginning of that year. The case involved a depreciation allowance with respect to the property acquired by the parent upon the liquidation of its subsidiary. The court remarked, however, that "it is agreed that the petitioner and the Iron Works were affiliated for excess-profits tax pur-

poses during the year 1917 * * *." The decision in *American Paper Exports* v. *Bowers*, 54 F. (2d) 508 (C. C. A. 2d), has no apparent bearing upon the question. In that case the court held merely that a single consolidated return should be filed for the entire year, in case a parent corporation organized during the course of the year becomes affiliated with a subsidiary already in existence and active from the beginning of the year.

Wilmington Steamboat Co. v. *Sturgess*, 52 F. (2d) 210 (N. J.), affirmed 55 F. (2d) 831 (C. C. A. 3d), is more nearly similar to the instant case on its facts. There the District Court indicated that if there was any loss to one of several affiliated corporations it could be deducted for excess-profits tax purposes because affiliation ceased upon liquidation of one of the affiliates. But the court held that on the facts there had been no loss and consequently its observations upon the question of affiliation lose much of their force. The Circuit Court of Appeals affirmed the determination on the question of fact and did not discuss the problem of affiliation adverted to by the lower court.

An entirely different situation is involved where all the stock of a subsidiary is sold to persons not identified with the affiliated group. Such a sale terminates all interest of the parent corporation in the subsidiary and its property. Any gain or loss thus established does not result from a transaction between the parent

and the subsidiary, and it should be recognized in determining the separate net income of the parent. In the present case, on the other hand, the parent merely took over the assets of the subsidiary, retaining, as before, its control through stock ownership. The apparent gain or loss in such circumstances results solely from a shifting of properties and accounts between members of the same affiliated group, which does not affect the financial situation of the enterprise viewed as a whole. In the case of a final dissolution, the surrender of the stock and the dissolution of the subsidiary have the same definitive qualities as a sale. In that case the subsidiary is extinguished; the parent corporation thereafter retains no interest in the subsidiary, any loss of investment or loans by the parent corporation, theretofore only potential, may be considered as fixed and determined. In the instant case the Sales Company was not dissolved until February, 1918.[2] Until that event there was no dissolution or surrender of the stock but merely a transfer of assets, and it could not be known what loss, if any (other than a loss on an intercompany trans-

[2] Although the petitioner in the court below conceded *arguendo* that the losses in question were sustained if at all in 1917, the principle contended for was that ostensible losses suffered by one of a group of affiliated corporations in an intercompany transaction during the period of affiliation are not allowable deductions upon the consolidated return by the group. In support of that principle here the petitioner feels justified in pointing out that such losses are not actually sustained by mere liquidation without dissolution.

action), the respondent would actually sustain upon its investment and loans.[3]

II

ANY LOSSES SUSTAINED BY THE RESPONDENT IN CONNECTION WITH TAKING OVER THE ASSETS OF ITS WHOLLY OWNED SUBSIDIARY UPON THE LATTER'S LIQUIDATION WERE STRICTLY INTERCOMPANY AND HENCE NOT ALLOWABLE DEDUCTIONS IN COMPUTING THE CONSOLIDATED NET INCOME OF THE RESPONDENT AND ITS SUBSIDIARY FOR 1917

The courts have repeatedly recognized as fundamental the principle that intercompany transactions must be eliminated in computing the consolidated net income of affiliated corporations. See *Utica Knitting Co.* v. *United States*, *supra*; *Packard Motor Car Co.* v. *United States*, 39 F. (2d) 991, 997 (C. Cls.), certiorari denied, 282 U. S. 848; *Lavenstein Corporation* v. *Commissioner*, 25 F. (2d) 375, 376 (C. C. A.

[3] The fact that the Commissioner allowed respondent a deduction for the losses in 1917 for normal tax purposes does not indicate that the position here urged is untenable. For normal tax purposes the respondent and the Sales Company were separate and independent entities, while for excess-profits tax purposes they were a single business enterprise. For the normal tax the income of each determined separately was the subject of tax; but for the excess-profits tax it was the consolidated income of both as a unit that was to be determined. In one case the fact of loss is controlling; in the other, the continuance of corporate existence and hence of affiliation. It does not follow that a loss has been sustained by a member corporation of an affiliated group because the loss was sustained in respect of the same subject matter by the corporation as an independent taxable entity. In any event, if the Commissioner's allowance of the deduction in 1917 upon the returns for normal tax purposes was erroneous, the respondent, of course, can not complain of an error by which it has benefited.

4th); *Fidelity National Bank & Trust Co.* v. *Commissioner*, 39 F. (2d) 58 (C. C. A. 8th).

The court below, while not expressly repudiating this accepted rule, held that transactions like those now involved were not intercompany in their nature, and that the departmental practice and regulations, if they purported to define them as intercompany, were not in accordance with the statute and hence could not be enforced.

We submit that the transactions resulting in the losses here in question were strictly intercompany. These losses occurred in dealings exclusively between the respondent and its wholly owned subsidiary, the Sales Company. The Circuit Court of Appeals took the contrary view, because the stock was not purchased directly from the Sales Company and because the Sales Company's inability to repay the advances arose from losses suffered in its dealings with third persons. But these facts are immaterial, for it was not the purchase of the stock or the previous unprofitable operations of the Sales Company which were the sources of the losses now claimed. The respondent actually suffered no loss either when it bought the stock or made the advances, or when the Sales Company sustained losses in the conduct of its business. The respondent's losses on account of its unpaid advances were suffered only when respondent having received all the assets of the Sales Company in partial satisfaction of its advances, it was evident that no more would be paid. The advances to the Sales Company and the partial repay-

ment to the parent were wholly and strictly intercompany transactions. It does not matter why the Sales Company could not respond in full.

While it is true that the stock was not purchased directly from the Sales Company, the price which was paid for it was an investment in its capital. The purchase of the shares created the intercompany relationship, and the losses resulting from their depreciation were incurred, if incurred prior to dissolution, in a transaction essentially intercorporate, namely, the investment by one corporation in the capital of its subsidiary. Furthermore, it was only by the transfer of remaining assets from one company to the other that the measure of the worthlessness of the stock was established. Had the shares been sold at a loss to an outsider, affiliation would have been ended and the sale would not have been an intercompany transaction, but that was not the case. Here the loss was necessarily an intercompany loss, since it represented merely the depreciation in the value of the respondent's interest in the assets of the Sales Company. Cf. *Fidelity National Bank & Trust Co.* v. *Commissioner, supra; Golden Cycle Corporation* v. *Commissioner*, 51 F. (2d) 927 (C. C. A. 10th).

Manifestly, if intercompany debts and losses incurred by the parent company through the exhaustion of capital reflected in the value of a subsidiary's stock which the parent continues to own and control, are not to be treated as intercompany transactions, there can be no true consolidated return of

the income of the affiliated group. The mandate of the Regulations could not be obeyed by treating the corporations as affiliated in computing their joint income, but as separate entities where their losses were involved. Nor could necessary computations of invested capital be made if affiliation is overlooked. It is only by this process that the losses in question could be recognized in 1917 while affiliation continued.

Until a definitive event, such as a sale to outside interests or a dissolution, any transfers of property between the respondent and its subsidiary were internal transactions within the affiliated business group. Although the *respondent's* potential loss on account of its investment in and advances to its subsidiary appeared certain in 1917, it was not a loss to the *business unit* consisting of the Sales Company and itself incurred in 1917. The losses actually incurred by the Sales Company in its operations during 1917 were allowed as deductions by the petitioner. This loss and losses of prior years were reflected in the depreciation of its stock and the exhaustion of its assets which rendered its debts uncollectible. Since there was no disposition of the stock nor any dissolution of the subsidiary in 1917, affiliation continued. The fact that this situation might have been easily avoided is not material. The tax laws are replete with instances where apparently formal action would alter the results reached, but the presence of some loopholes in the taxing statutes does not warrant judicial expansion of their number. See *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 330. Tax liabilities

must be determined by what was in fact done and not by what might have been done.

If, as the Circuit Court of Appeals holds, the losses in question may be deducted upon the consolidated return of the respondent and the Sales Company, it results that the excess-profits tax is to be computed upon the basis of the *separate* net income of the respondent but at rates determined by the use of the *consolidated* invested capital of both corporations. Such a result finds no sanction in law and contravenes the requirement of the statute that the excess-profits tax be determined on the basis of consolidated net income *and* invested capital. Further, the respondent in effect seeks to carry forward to the year 1917 all the operating losses of the Sales Company in prior years and deduct the same from income in 1917, for which there is no authority in the statute. To allow such losses is to permit the respondent indirectly to apply against its income, in computing 1917 consolidated net income, losses sustained by the Sales Company and properly allowable to it in prior years. This Court has said that such a result may not be accomplished directly (*Woolford Realty Co.* v. *Rose*, 286 U. S. 319; *Planters Cotton Oil Co.* v. *Hopkins*, 286 U. S. 332), and it should not be permitted indirectly.

If the decision below be sound it would seem that the purpose of the Revenue Acts to ignore apparent gains and losses arising from transactions between affiliated corporations will be frustrated. It permits mere transfers of assets among affiliated corporations to give rise to gains and losses, appropriate enough

when individual taxpayers are concerned, but only apparent and not real where taxes are laid on a single business enterprise in which transactions between its parts are disregarded.

III

EVEN UNDER THE HOLDING OF THE COURT BELOW A RECOMPUTATION OF RESPONDENT'S TAX LIABILITY FOR 1917 WOULD RESULT IN THE SAME DEFICIENCY AS THAT DECIDED UPON BY THE BOARD OF TAX APPEALS

Even should respondent's contention that affiliation in this case was terminated by liquidation be deemed legally correct, which we deny, we believe that the decision of the Board of Tax Appeals should have been affirmed by the court below. The stipulated facts show that the liquidation of the subsidiary was consummated December 31, 1917. There is nothing in the record to indicate that such liquidation occurred prior to the last moment of that day, and indeed respondent's own conduct at the time indicates that it did not regard affiliation as having ceased at any time during the year. Had affiliation ceased during the year, a computation of the excess-profits tax upon the basis of respondent's separate income for the remaining portion of the year would have been proper (see *Remington-Rand, Inc.*, v. *Commissioner*, *supra*; *Sweets Co. of America* v. *Commissioner*, 40 F. (2d) 436 (C. C. A. 2d); cf. *American Paper Exports, Inc.*, v. *Bowers*, *supra*); but no return for that portion of the year was filed and no effort to file one was ever made, so far as the record discloses. See *Ludlow Valve Manufacturing Co.* v. *Durey*, 57 F. (2d) 583 (N. D. N. Y.).

The respondent's contention was that the losses in question were deductible in computing the consolidated net income of the affiliated companies.[4] This we have shown was not permissible. But whether our contention is sound or not, the facts of this case disclose that affiliation terminated, if at all, coincidently with the end of the tax year. (R. 11.) Even if, for the sake of the argument, the conclusion of the court below that the loss occurred outside the period of affiliation—that is, upon liquidation—be accepted, the respondent's excess profits tax was nevertheless correctly determined by the Commissioner and sustained by the Board, because so far as appears no income was received by the respondent in 1917, after affiliation terminated, against which such loss might have been offset.[5]

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[4] Before the Board of Tax Appeals it was not contended by the respondent that the statutory affiliation ceased prior to the year 1918. (R. 20.) Although the Circuit Court of Appeals concluded that the losses in question were suffered in 1917, and outside the period of affiliation, the respondent's claim before the Bureau of Internal Revenue was that these losses, less the operating loss of the Sales Company in 1917, should be allowed in connection with the audit of its consolidated return (R. 5, 19), and the disallowance of this claim was the basis of its petition for a redetermination of the resulting deficiency by the Board of Tax Appeals (R. 5).

[5] The taxpayer had the burden of proving that the net income of the affiliated group prior to the termination of the affiliation, if it occurred by the liquidation of the Sales Company, as held by the court below, was less than the amount of $1,600,363.52, as determined by the Commissioner. See *Niles Bement Pond Co.* v. *United States*, 281 U. S. 357, 361; *Reinecke* v. *Spalding*, 280 U. S. 227, 232–233.

This anomalous situation was not present in *Remington-Rand, Inc.*, v. *Commissioner, supra*, where affiliation was terminated February 28, 1920, and the profit was taxed during the last ten months of 1920, nor in *Burnet* v. *Riggs National Bank, supra*, where it was held that affiliation terminated June 10, 1922, and the loss was allowed as against separate income for the remainder of that year.

For these reasons a recomputation of the income and profits tax liability of the respondent for the year 1917, even in accordance with the conclusions of the court below, would result in the same deficiency as that set forth in the decision of the Board of Tax Appeals from which respondent appealed to the Circuit Court of Appeals. The decision of the Board, even though based upon reasoning deemed by the court below to be erroneous, was nevertheless the same that should be rendered on the basis of the conclusions of the Circuit Court of Appeals. We do not acknowledge the correctness of those conclusions, but we submit that, even should their validity be accepted, the court below should have affirmed the decision of the Board of Tax Appeals. The Circuit Courts of Appeals have power to reverse only "if the decision of the Board is not in accordance with law." Section 1003 (b) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 110 (U. S. C. Title 26, Sec. 1226). See *Houston* v. *Commissioner*, 53 F. (2d) 445 (C. C. A. 3d); *Thom* v. *Burnet*, 55 F. (2d) 1039 (App. D. C.). In this sense the word "decision" means the Board's order specifying the amount of the deficiency. Reve-

nue Act of 1928, Sec. 601, c. 852, 45 Stat. 791, 871–872 (amending Revenue Act of 1924, Sec. 906; U. S. C. Sup. V, Title 26, Sec. 1217).

CONCLUSION

The decision below should be reversed and that of the Board of Tax Appeals affirmed.

Respectfully submitted.

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NOVEMBER, 1932.

APPENDIX

Revenue Act of 1916, approved September 8, 1916, c. 463, 39 Stat. 756, 767:

> SEC. 12. (a) In the case of a corporation, * * * organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—
>
> * * * * *
>
> Second. All losses actually sustained and charged off within the year * * *.

Revenue Act of 1917, c. 63, 40 Stat. 300, 305, 307:

> TITLE II.—WAR EXCESS PROFITS TAX
>
> SEC. 206. That for the purposes of this title the net income of a corporation shall be ascertained and returned * * * for the taxable year upon the same basis and in the same manner as provided in Title I of the Act * * * approved September eighth, nineteen hundred and sixteen, as amended by this Act, * * *.
>
> SEC. 213. That the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall make all necessary regulations for carrying out the provisions of this title, * * *

Revenue Act of 1921, approved November 23, 1921, c. 136, 42 Stat. 227, 309, 319:

> CONSOLIDATED RETURNS FOR YEAR 1917
>
> SEC. 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corpora-

tions and domestic partnerships that were affiliated during the calendar year 1917.

(b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided*, That such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital. * * *

(*c*) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

SEC. 1303. That the Commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act.

* * * * *

Regulations 33 (Income Tax), promulgated under the Revenue Acts of 1916 and 1917:

ART. 147. *When (losses) deductible.*—The deduction for losses must represent losses * * * which were charged off and actually sustained within the year as evidenced by closed and completed transactions.

* * * * *

ART. 151. *Bad debts.*—Losses which may be properly deducted from gross income on account of bad debts or doubtful accounts are those losses which have been definitely ascertained to have occurred and which were charged off during the year for which the return is made. * * *

Regulations 41 (War Excess Profits Tax), promulgated under the Revenue Act of 1917:

ART. 77. *When affiliated corporations must furnish information as to intercorporate relations.*—For the purpose of the excess-profits tax every corporation will describe in its return all its intercorporate relationships with other corporations with which it is affiliated, and will furnish such information in relation thereto as will enable the Commissioner of Internal Revenue to compute the amount of the tax properly due from each corporation on the basis of an equitable and lawful accounting.

For the purpose of this regulation two or more corporations will be deemed to be affiliated (1) when one such corporation owns directly or controls through closely affiliated interests or by a nominee or nominees, all or substantially all of the stock of the other or others, or when substantially all of the stock of two or more corporations is owned by the same individual or partnership, and both or all of such corporations are engaged in the same or a closely related business; or (2) when one such corporation (a) buys from or sells to another products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or (b) in any way so arranges its financial relationships with another corporation as to assign it a disproportionate share of net income or invested capital.

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